



European Bank
for Reconstruction and Development

North Western Regional Waste Water Project

State Sector Project Assessment

Prepared in line with the EBRD's Access to Information Policy¹

Country	Croatia
Sector	Municipal and environmental infrastructure
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Operation Description

Međimurske Vode d.o.o. ("the Company", "Client", "MV" or the "Borrower") is a regional operator and provider of water and wastewater services in its County, incorporated in Croatia and jointly owned by the city of Cakovec, Prelog and Mursko Središće, and 23 municipalities within the County of Međimurje ("North-Western region" or the "County"). At the time of signing, the Company managed 1,070 km of the water supply system (~33,000 household connections), but only 164 km of sewage network (~8,300 domestic and ~900 non-domestic connections) – highlighting the need for an upgrade and extension of the sewage network.

MV approached the Bank to help co-finance priority investments in the extension of the wastewater collection and treatment in the North-Western region of Croatia, thereby increasing coverage of the sewage services in the area and helping the Company reach compliance with EU directives, while reducing the pollution of the Drava river. Total project investment costs were estimated at ca. EUR 49.5 million, with EU Funds contributing EUR 25 million of financing, MW financing and the EBRD providing a EUR 8 million loan to the Company. The project consisted of four phases. Phase I, which includes extension of the sewage network (particularly collectors and pumping stations) and construction of a wastewater treatment plant ("WWTP") for the settlements of Totovec, Novo Selo na Dravi, Sandrovec and Kursanec in the City of Cakovec suburban area, which was financed by the EBRD loan in the amount of up to EUR 8 million ("Project"). The three other stand-alone phases comprising priority investments are: Phase II, which included extension of the existing sewage system centred on the City of Cakovec to settlements West of Cakovec,; Phase III, which included construction of a sewer

¹ As required by Section IV paragraph 1.4.8 of EBRD's Directive on Access to Information (2019), the Bank shall disclose information (excluding Confidential information) contained in Operational Performance Assessment (OPA) reports for State Sector Projects selected for extended review, within 60 calendar days after completion of the relevant OPA report.

collector Prelog-D.Dubrava-Kotoriba in the south-east of the County to transfer sewage to the WWTP; Phase IV, which included construction of a new separate sewage system and WWTP to the City of Mursko Središće in the north of the County. The other three phases did not have a detailed implementation schedule as they depended on the availability of funding (loan and grant financing) and overall implementation timeline.

The loan was approved by the Board in May 2011 and signed in December 2012, with a tenor of 10- years, providing financing of up to EUR 8.0 million. The Loan was supported by a Municipal Support Agreement (“MSA”) between the Bank and the City of Čakovec, the Municipality of Nedelišće and the Municipality of Prelog, and backed by a Public Service Contract (“PSC”) between the Company and the City and a Project Support Agreement (“PSA”) between the Borrower and the Croatian Water Agency (“CWA”). In October 2014, the Bank approved the amendment of the loan agreement (signed in November) that revised the security package. No other operations or exposure to the Borrower exist.

While no changes to the scope of the Project were observed, project implementation has been delayed due to a protracted process of the FOPIP consultant selection, and a delay in construction of the WWTP. Delays in the implementation of WWTP capex were caused by (i) changes in the original concept design of the plant, (ii) slow-construction works, (iii) financial problems of the leading contractor in the construction consortium and others. Construction works on the wastewater collection network were completed in July 2016, while the physical completion of the WWTP took place in July 2017, when the plant entered trial mode.

The Project was successfully completed mid-2018, following the correction of identified deficiencies during the trial mode and successful handover of the WWTP. This was the first regional wastewater programme financed by the Bank in Croatia without recourse to the municipalities.

Relevance

The objectives of the Project are consistent with the Bank’s Strategy for Croatia in terms of supporting improvement of local infrastructure in water and wastewater area and diversifying its investments into medium-sized cities outside the capital. The strategy also states: “the Bank will facilitate development of MEI projects through improved contractual arrangements to clarify service levels and expected performance of municipal utilities”. The Project is also consistent with the Municipal and Environmental Infrastructure Operations Policy, which emphasises decentralisation through lending directly to municipalities and/or municipal enterprises and commercialisation of environmental services.

Appropriate financing structure was based on the findings of in-house due diligence and consultants’ report, as well as the Client’s and Project’s requirements, which resulted in: (i) optimal investment budget, – of EUR 8 million as at the date of signature, and (ii) appropriate tenor of the financing package i.e. by 10 year loan covering implementation of the project.

Overall, the structure was adapted to the Company’s needs, while the team’s experience in similar projects

within the sector, analysis and requirements at approval led to a robust security package. Moreover, the Loan was backed by a PSC and PSA.

To help MV increase operational efficiency and successfully complete and implement the Project, donor-funded FOPIP consultants were engaged. In order to ensure adherence with national and EU environmental requirements and EBRD Performance Requirements, consultants were engaged to prepare an Environmental and Social Action Plan and Stakeholder Engagement Plan.

The clarity of expected results was formalised within the TIMS monitoring benchmark, whereby transition impact was linked to positive demonstration of non-recourse lending, together with improved operational and financial performance, and environmental standards following the investment project and associated FOPIP. Additionally, positive impact was seen in introduction of PSC between the Company and the three largest municipalities in the service area. Please see below for detailed overview of the objectives.

The EBRD's involvement was additional due to (i) its capacity to properly structure long-term financing for a regional utility company without recourse (particularly without sovereign or sub-sovereign financial guarantee), (ii) its ability to help structure and oversee the corporate development of the Company and (iii) the Bank's conditionalities on keeping stringent environmental, social and transition impact standards.

Namely, while local commercial banks were, at the time, willing to provide direct financing to local authorities (cities and municipalities), less appetite existed for lending to regionally-owned companies without financial guarantees. The EBRD was able to provide appropriate long-term funding, with tenor and grace period aligned with the Project's requirements when the availability of financing with longer tenor was scarce. Furthermore, under the donor-funded FOPIP, the Bank procured consultants who supported commercialisation through preparation and implementation of a corporate development plan with improvements in such areas as tariff setting, business planning, managerial accounting and long term financing and others. Finally, after conducting ESDD including a site visit, an ESAP was developed to mitigate identified E&S issues and impacts during preparation, construction and operation of the Project. Most notably, the Client implemented a Manual of

Integrated Management System Processes and a range of environmental / health & safety procedures, guidelines and annual reports related to the Project. According to the latest implementation board, all actions of the ESAP have been completed.

Effectiveness

When analysing the benchmarks, the Project was designed to deliver transition impact in the following areas:

- i. *Institutions, laws and policies that promote market functioning and efficiency*, supported by the signing of a PSC between the Company and the City and implementation of benchmarks established within;
- ii. *Demonstration of Successful Commercialisation*, through non-recourse project structuring, and introduced TC for FOPIP for the Company aimed at enhancing operational performance, commercialisation through preparation and implementation of a corporate development plan, and creditworthiness by improving operational costs;
- iii. *Regulatory Framework*, by improving the existing tariff structure by ensuring timely tariff adjustments and reduction of cross subsidies between consumer groups as per FOPIP proposal;
- iv. *Setting Standards of Corporate Governance and Business Conduct*, supported by compliance with the EBRD procurement rules and implementation of the project on-time and within budget.

Chief risks to transition impact related to the Company's financial performance, possibility of delays with project implementation, preparation of the PSC and achievement of objectives set in the PSC.

While the 2-stage selection process for the FOPIP consultants took longer than expected, upon final selection of BRL/International Office for Water in September 2014, the consultants assisted the Client in preparation of the PSC. After initial delays, the consultants completed the FOPIP and PSC exercises in May 2016. The final FOPIP report was presented to the management of MV who fully accepted the report, committing to implement the outlined recommendations, including the revised tariff methodology and business strategy with long-term operations plan.

The construction works on the sewage infrastructure commenced in September 2014, while construction of WWTP and supporting infrastructure started in March 2015. Physical implementation has been delayed, due to interruptions in the tender process preparation and subsequent delays in the preparation of the project design by the contractor, which was out of the control of the Client and the Bank. The construction works on the wastewater collection network and WWTP completed in July 2016 and July 2017, respectively.

Following FOPIP completion, the management accepted a new tariff methodology that would lead to elimination of cross-subsidies. Originally, instead of making several adjustments over a couple of years, the Client planned to make a single tariff revision that would lead to equalisation once the project is fully implemented (completion of WWTP). On account of delays in acceptance of the completion report by the Client, and a new set of regulation for the water sector adopted in 2019, the tariff reform was postponed. Tariff reform with respect to elimination of cross subsidies was eventually incorporated in the Croatia's National Reform Plan for the periods 2018, 2019 and 2020, which envisaged tariff equalisation upon successful completion of the regionalisation process in the water & wastewater sector. Due to negative external factors (Covid-19 pandemic, war in Ukraine, etc.) these reforms of Croatia's water sector have eventually been postponed in implementation, but still remain a part of Croatia's commitment toward the EU and a precondition for the utilisation of certain funds from the National Recovery and Resilience Plan. As such, the reforms are expected to materialise in the next 2-3 years.

As outlined above, the majority of benchmarks have been achieved or partly achieved, with only the Regulatory Framework remaining not achieved.

A summary of the TI benchmarks is presented in the table below.

Table 2: Transition Monitoring Benchmarks

Monitoring indicators			
Transition impact objectives	Monitoring benchmarks		BM assessment
1. Institutions, laws and policies that promote	1.1 Signing of the PSC between the		Achieved

market functioning and efficiency	Company and the City		
	1.2 Implementation of benchmarks established in the PSC and performance against benchmarks disclosed to customers on a regular basis		Partially Achieved
2. Demonstration of successful commercialisation	2.1 Implementation of the corporate governance programme (incl. business strategy with long-term operations plans)		Achieved
3. Regulatory Framework	3.1 – 3.4 Reduce the price differences between the various customer groups to (i) 50 per cent, (ii) 31 per cent, (iii) 14 per cent and (iv) eliminate such differences		Not Achieved
4. Setting standards of corporate governance and business conduct	4.1 Investment project implemented on time and within budget		Partially Achieved

Key project objectives included: (i) good financial and operational performance, (ii) on-time project implementation including completion according to the

timeline and within the budget, and (iii) to achieve sustainability in accordance with Croatian and EU regulations with respect to implemented wastewater infrastructure and services.

As highlighted in section below, the Company continues to exhibit good financial performance on account the Project's implementation and improved operational performance owing to adoption of the FOPIP report. Whilst Project completion was behind due to delays on the consultant's side, as well as changes in the WWTP design, building permit approval and consequent delay in the start of construction works, the Project was successfully completed in mid-2018 under budget. Regarding sustainability of services and infrastructure, the plant's operations are confirmed to be stable and fully compliant with statutory quality of output of purified water requirements, and the output wastewater from the WWTP is now in compliance with EU effluent quality standards (expanded below).

Please refer to sections below for detailed information on associated donor-funded activities, their implementation and contribution to the achievement of operational objectives and outcomes.

Efficiency

Due diligence was carried out predominantly in-house and included meetings in Croatia between the EBRD team and MW. Based on the EBRD's strategy, the findings, the team's experience in similar projects and the identified needs of the Borrower, the main risks were defined and respective TC assistance prepared.

To mitigate the risks identified in relation to the project, several technical assistance programmes have been initiated and a sound financial structure set in place. As explained in the Efficiency section, the implementation of FOPIP recommendations and standards, signing of the PSC and PSA had a positive impact on Company financial performance and debt servicing capacity. Furthermore, the established PIU was supported by donor-funded project implementation consultants, which aided in procurement, design and contract supervision, ultimately leading to project cost savings.

Notwithstanding robust structuring, the protracted process of FOPIP consultant selection and delays on the consultants' side prolonging the signing of the PSC led to a slower tendering process. While physical

implementation has been delayed, this was mainly the result of delays in the signing of contracts with selected construction companies due to changes in the WWTP design and unexpected delays in the evaluation of submitted tenders on the employees' request, as opposed to the Bank's involvement or project structuring.

Client relationship management on the Project was excellent. All required disbursements, consents, waivers and amendments were processed in a timely fashion..

In terms of monitoring and reporting, the Company has provided regular project progress reports, financial reports and annual reports on environmental and social issues to the Bank, and fully complied with financial covenants and ratios. Communication has been efficient and transparent and all financing has been utilised in accordance with legal agreement.

As a result of the Bank's involvement, the Company successfully implemented the WWTP for inhabitants in three settlements – Novo Selo na Dravi, Totovec, Krusanec and Sandrovec. After addressing the shortcomings identified during the WWTP's trial period, it was concluded that the plant's operations are stable and fully compliant with statutory quality of the output of purified water requirements, with the removal of 94-98% of the total input load from the second stage of treatment, in line with national laws and regulations. The output wastewater from the WWTP is now in compliance with EU effluent quality standards. The implemented WWTP is noted to be sufficient to meet the existing demand of inhabitants in these settlements. Development of sewage and WWTPs across the North-Western region is still in progress according to the latest Annual Environmental & Social Report and will be implemented under EU programmes.

On the Company level, the actions from the procured ESAP and SEP have been completed and fully implemented, with key metrics integrated into the Client's annual OSH and client satisfaction survey reports. Environmental management issues are recorded in monthly progress reports (no issues noted). With the signing of the PSC and implementation of FOPIP recommendations and standards, the majority of transition impact objectives of the project have been achieved. Regulatory framework in the aspects of tariff adjustments and reduction of cross-subsidies between different

customer groups for a universal tariff system are still lacking. It should be noted, however, that the Borrower already operates on a full-cost recovery basis, as mandated by the signed LA and as per the Water Services Act from 2019. The need for the reform of the water sector is set as one of key priorities at the central Government levels and as such is included under different reform agendas for Croatia, as well as part of the Croatia reform agenda/plans for the utilisation of the National Recovery & Resilience Programmes under the EU. This ensures that the reform of the entire sector, with full regionalisation and tariff adjustments, will happen over the mid-term.

Implementation Summary

The Project enabled increased coverage of sewage services in the North Western region of Croatia, while reducing the pollution of the Drava river, by co-financing priority investments in the extension of wastewater collection network and construction of a wastewater treatment plant (“WWTP”) for the settlements of Totovec, Novo Selo na Dravi, Sandrovec and Kursanec in the City of Cakovec suburban area. The Project was successfully completed mid-2018, with a time delay, but with significant capex savings.

The Project is an example of non-recourse financing of a regional wastewater programme. It ensured adherence to environment and social standards, which helped the regional operator and provider water and wastewater services reach full compliance with national laws, regulations and EU effluent quality standards regarding the output wastewater from the WWTP. The Company has fully implemented the Environmental and Social Action Plan.

As part of Transition Impact, the Project benefited from donor-funded FOPIP consultants who supported the commercialisation of the Company through preparation and implementation of a corporate development plan with improvements in such areas as tariff setting, business planning, managerial accounting and long-term financing. Additionally, to ensure a high-quality and cost-effective service provision, and monitor the progress in quality improvement of service provision in the form of key performance indicators, a Public Service Contract was signed between the Company and the City of Cakovec, the Municipality of Nedelisce and the Municipality of Prelog.